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PUBLIC UTILITIES—THE AFTERMATH OF THE HOPE
CASE IN KENTUCKY (II)*

Not only has the celebrated *Hope* case¹ had a noticeable effect upon rate determination of public utilities by federal agencies, but it has also had an impact upon rate determination by state commissions. It is true that state public service commissions still adhere to the various traditional rate-making formulae, but the *Hope* decision has been used by several state commissions, including Kentucky, as a basis for moving away from the "fair value" rule as embodied in *Smyth v. Ames*.² The present attitude of the Kentucky Public Service Commission and Court of Appeals³ toward the valuation of property in a utility rate case in Kentucky will be considered in this note as well as the question of whether or not the Kentucky Commission may use the decision in *Hope* as a means of avoiding "fair value" in view of the Kentucky Public Service Act.⁴

The various state court decisions since the *Hope* case have been grouped into four categories: (1) those continuing their pre-*Hope* policy of original cost or prudent investment; (2) those faithful to the fair value rule despite the opportunity offered by the *Hope* case; (3) those adopting a cost method, though ostensibly adhering to the fair value rule; (4) decisions explicitly adopting either original cost or prudent investment as a result of *Hope*.⁵ Kentucky has been placed in category (3), which includes those states that have adopted original cost as the measure of fair value after the *Hope* case.⁶

* This note, primarily concerned with the rate base problem as it is presented to Kentucky courts, is Part II of a two-part survey. Part I, which appeared in the Winter issue of the Kentucky Law Journal, treated the rate base problem from a federal and Supreme Court perspective.

¹ Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

² 169 U.S. 466 (1898).

³ The Court of Appeals has decided very few rate cases in which property valuation has been the subject of the litigation. However, the Court has approved the Commission's sole use of original cost in determining the rate base. *Citizens Telephone Co. v. Public Service Commission*, 247 S.W. 2d 510 (Ky. 1952).

⁴ Ky. Rev. Stat. sec. 278.290:

"... the Commission may ascertain and fix the value of the whole or any part of the property of any utility in so far as the value is material to the exercise of the jurisdiction of the Commission, and may make revaluations from time to time and ascertain the value of all new construction, extensions and additions to the property of the utility. In fixing the value of any property under this subsection, the Commission shall give due consideration to the history and development of the utility and its property, original cost, cost of reproduction as a going concern, capital structure, and other elements of value recognized by the law of the land for rate-making purposes."

⁵ Rose, "The Hope Case and Public Utility Valuation in the States," 54 Colum. L. Rev. 188, 190 (1954).

⁶ *Id.* at 200.

It is clear from the language employed in the Kentucky Public Service Act that the legislature adopted the fair value rule set forth in the *Smyth* case.⁷ Although the Commission is aware of the portion of the Public Service Act requiring it to use fair value as one of the elements in determining rates,⁸ it has nevertheless displayed nothing but hostility to reproduction cost new. In one of the first of its determinations after the *Hope* case, the Commission rejected evidence of reproduction cost new because it was not clear whether reproduction prices were based upon present-day costs for single units or for quantity lots.⁹ At the same time the Commission also expressed disapproval of reproduction cost new when it said:

A great deal of [the property] . . . has been in service for more than thirty years and is so obsolete that it cannot be reproduced from purchases in the open market any more than a '1918 Model T' can be so purchased. Consequently, any reproduction cost study predicated upon replacing the existing plant in every identical detail is bound to descend from mere guesswork to pure speculation and to become too unrealistic to carry any considerable weight in calculating a rate base.¹⁰

The Commission has further stated:

The determination of existing depreciation is also a speculative matter. How can one determine the depreciation that has taken place in an electric light bulb that is still burning?¹¹

The above statements are only a few of many which are indicative of the Commission's hostility to reproduction cost new. As a result of this hostility the Commission has modified the traditional concept of fair value by giving mere lip-service to the reproduction new requirement of the statute¹² while placing the greater emphasis upon original cost, or even by using original cost as the only element of fair value. This result has been approved by the Court of Appeals.¹³

⁷ The Commission, in fixing the value of utility property, is required to give due consideration to (1) the history and development of the utility and its property, (2) original cost, (3) cost of reproduction as a going concern, and (4) other elements of value recognized by the law of the land for rate-making purposes. This is essentially the same formula set forth in *Smyth v. Ames*, 169 U.S. 466, 546-47 (1898).

⁸ Re Lexington Telephone Company, 75 P.U.R. (n.s.) 1, 3 (Ky. P.S.C. 1948).

⁹ Re Southern Bell Telephone and Telegraph Co., 76 P.U.R. (n.s.) 33 (Ky. P.S.C. 1948).

¹⁰ Id. at 39.

¹¹ Re Citizens Telephone Co., 83 P.U.R. (n.s.) 129, 136 (Ky. P.S.C. 1950).

¹² Re Southern Bell Telephone and Telegraph Co., 6 P.U.R. 3rd 18 (Ky. P.S.C. 1954); Re Western Kentucky Gas Co., 93 P.U.R. (n.s.) 90 (Ky. P.S.C. 1953); Re United Fuel Gas Co., 95 P.U.R. (n.s.) 65 (Ky. P.S.C. 1952); Re Ashland Home Telephone Co., 90 P.U.R. (n.s.) 16 (Ky. P.S.C. 1951).

¹³ *Citizens Telephone Co. v. Public Service Commission*, 247 S.W. 2d 510 (Ky. 1952).

The opponents of reproduction cost new advance the theory that utility property is not freely bought or sold on the open market, and, therefore, is not the type of property ordinarily considered to have an exchange value and so any estimate as to its reproduction cost must be established by opinion evidence, which necessarily involves a certain amount of speculation.¹⁴ This is a difficulty that has been recognized by Chief Justice Hughes, but he concluded that this did not justify its rejection:

. . . [T]he criteria at hand for ascertaining market value, or what is called exchange value, are not commonly available. The property is not ordinarily the subject of barter and sale and, when rates themselves are in dispute, earnings produced by rates do not afford a standard for decision. *The value of the property or rate base, must be determined under these inescapable limitations.*¹⁵ (Italics added)

Thus, it would seem that the weaknesses of reproduction cost *do not* justify the complete disregard of that element of the rate base, particularly since these weaknesses were obviously known by the Kentucky Legislature at the time reproduction cost new was included in the rate base formula.

The Kentucky Commission, as previously pointed out, has rejected reproduction cost new as a method of evaluating utility property for rate-making purposes as being too conjectural and unworkable. The rationalization for this result has been grounded on the decisions of *Hope* and *Canadian River Gas Co. v. Federal Power Commission*.¹⁶ In the latter case the Federal Power Commission rejected evidence of reproduction cost new saying the estimates were too conjectural to have probative value and adopted original cost as the only reliable evidence as to property values. Of course, this result was in keeping with the *Hope* case, which permits the use of a rate base other than fair value, if the Legislature chooses, in so far as the Federal Constitution is concerned. However, if the state legislature has set forth specific statutory standards prescribing the method by which the rate base is to be determined, then the state commission is not free to resort to *Hope* but is bound to adhere to the state statute.¹⁷ It has been said that:

The effect of . . . [the *Hope*] decision is to free the state commissions so far as the federal constitution is concerned from any restrictions in their choice of a rate base. It follows that these commissions need

¹⁴ *Los Angeles Gas and Electric Corp. v. Railroad Commission of California*, 289 U.S. 287 (1933).

¹⁵ *Id.* at 305.

¹⁶ 324 U.S. 581 (1945).

¹⁷ Joslin and Miller, "Public Utility Rate Regulation: A Re-Examination," 43 Va. L. Rev. 1027, 1048-49 (1957).

conform only to their state laws in establishing property valuations for rate making purposes, and that the state legislatures may in their discretion prescribe fair value, prudent investment or any other rate base.¹⁸

Thus, it would seem that the Kentucky Public Service Commission is in error in rejecting evidence of reproduction cost as required by the state statute and by relying solely upon original cost as the method for property valuation. In so doing the Commission is equating the word "value" only with "original cost." This cannot logically be done when the legislature has specifically stated that "value" also includes "reproduction cost new."¹⁹

The conclusion that the Commission is in error in rejecting evidence of reproduction cost new is further strengthened by the fact that the Kentucky Legislature has taken no action to change the statute. Kentucky's first Public Service Act was enacted in 1934. This Act was subsequently amended in 1952, but the Amendment did not change in any manner the formula regarding property valuation but merely combined two statutes into one.²⁰ It can be properly assumed that in 1952, some eight years after the *Hope* decision the legislature was familiar with both the economic theories concerning rate making and the opportunities offered by *Hope*. Therefore, the failure of the legislature to act when it amended the statute in 1952 is of the utmost importance in formulating the legislative intent in regard to rate-making. The legislature was then free to adopt some other standard other than fair value, but it chose not to do so, and its choice must be given significance.

It must be remembered that rate-making is essentially a legislative act²¹ and that the Commission, a statutory creature, is bound to follow the statutes of the legislature.²² Merely giving lip-service to a legislative mandate and then proceeding to adopt a less burdensome formula does not satisfy either the letter or the spirit of the law. For the Commission to base its determination solely upon the capital actually expended, without considering the reproduction cost of the property actually used in the public service, amounts to legislation. This is beyond the power of both the Commission and the Court of Appeals.

Nor can it be logically argued that the legislature abandoned its previous position when the *Hope* decision was advanced, since exist-

¹⁸ Rose, "The Bell Telephone System Rate Cases," 37 Va. L. Rev. 699, 701-02 (1951).

¹⁹ See note 4 *supra*.

²⁰ Ky. Rev. Stat. sec. 278.290.

²¹ Joslin and Miller, *supra* note 17, at 1037.

²² Re Lexington Telephone Co., 75 P.U.R. (n.s.) 1 (Ky. P.S.C. 1948).

ing legislation was not changed after the *Hope* decision. If the legislature had in fact changed its position it seems that it would have done so in a clear and convincing manner, especially in 1952 when it took the time to amend the Public Service Act.

A situation comparable to that in Kentucky existed in New York prior to the decision of *New York Telephone Co. v. Public Service Commission*.²³ In that case the Commission had denied the application of the New York Telephone Company for an increase in telephone rates amounting annually to \$68,850,000. Petitioner's claim of error was that the Commission refused to receive evidence of the alleged present value of its property actually used in the public service. This claim of error was based entirely on statutory language contained in sec. 97(1) of the Public Service Law, which provides that the determination of rates is to be made 'with due regard, among other things, to a reasonable average return upon the value of the property actually used in the public service.'²⁴ Petitioner contended that this language was mandatory and therefore required the Commission to adopt a present fair value rate base. The Commission, on the other hand, contended that the language quoted was merely an historical accident and, therefore, without significance. The Commission further contended that present fair value as a rate base was abandoned as a constitutional requirement as a result of the *Hope* case.²⁵ The New York court held that the exclusion of evidence which would have been material in the computation of a fair value rate base was reversible error since reproduction cost less depreciation was an indispensable ingredient to be considered in fixing the present value of utility property. The court further stated that the *Hope* case did not free the Commission from the use of the legislative formula and that the legislature had shown no sign of abandoning fair value.

The Kentucky Commission and the Court of Appeals would do well to decide the next Kentucky rate case in light of this New York opinion.

There are at least three interests that must be protected in every rate case. These are the interests of the consumer, the public, and the utility, which includes the investor.²⁶ This note is not designed nor intended to be too favorable to the utility interest but at times in recent years it seems that the utility and the Commission have become adversaries, and a definite note of antagonism has been detected.²⁷ It

²³ 286 App. Div. 28, 142 N.Y.S. 2d 68 (1955).

²⁴ N. Y. Public Service Law sec. 97(1).

²⁵ *New York Telephone Co. v. Public Service Commission*, 286 App. Div. 28, 142 N.Y.S. 2d 68 (1955).

²⁶ Joslin and Miller, *supra* note 17, at 1035.

²⁷ *Id.* at 1036.

must be remembered that there has been a tremendous increase in both consumers and technological advancements. In order to supply the needs of the increasing consumer and to keep pace with technological advances and maintain the present plant, all of which the public interest demands, the utility must obtain huge sums of money. Such sums cannot be obtained if the utility is continually regulated "in this post-1945 era under guiding principles and concepts which had their inception during a period of time when both the economic, social, and legal conditions differed markedly from those existing currently."²⁸

The sole use of original cost is certainly unfair to the utility and its investors since most utility plants were built during a time when economic conditions were much lower than today. On the other hand, the sole use of reproduction cost new would not be feasible since this would favor the utility and result in exorbitant rates. The desirable situation as far as result is concerned would be a reconciliation of the two theories of rate-making, with both clearly reflected in the rate base. The use of reproduction cost new might possibly lengthen the determination process, but this fact should not discourage its use since it is vitally necessary to the protection of all interests concerned. Of course, the ideal solution would be to develop an entirely new system of rate-making, which state legislatures and state commissions, in absence of specific statutory provisions, are now free to do under the rule of the *Hope* case. But until a more satisfactory formula is found, the reconciliation formula of original cost and reproduction cost new, which is embodied in the Kentucky Public Service Act, should be followed.

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²⁸ Id. at 1033.